

NO. 18641

IN THE UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

FOREST G. SMITH, JR. and  
ROSE MARY SMITH,

Petitioners,

vs.

COMMISSIONER OF INTERNAL  
REVENUE,

Respondent.

---

REPLY BRIEF FOR THE PETITIONERS

---

ON PETITION  
FOR REVIEW OF DECISION OF  
THE TAX COURT OF THE UNITED STATES

---

**FILED**

AUG 20 1963

FRANK H. SCHMID, CLERK

ERNEST R. MORTENSON  
EUGENE HARPOLE  
961 East Green Street  
Pasadena, California

Attorneys for Petitioners



NO. 18641

IN THE UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

FOREST G. SMITH, JR. and  
ROSE MARY SMITH,

Petitioners,

vs.

COMMISSIONER OF INTERNAL  
REVENUE,

Respondent.

---

REPLY BRIEF FOR THE PETITIONERS

---

ON PETITION  
FOR REVIEW OF DECISION OF  
THE TAX COURT OF THE UNITED STATES

---

ERNEST R. MORTENSON  
EUGENE HARPOLE  
961 East Green Street  
Pasadena, California

Attorneys for Petitioners



## TOPICAL INDEX

	<u>Page</u>
Table of Authorities	ii
OPINION BELOW	1
JURISDICTION	1
QUESTION PRESENTED	1
STATUTES AND REGULATIONS INVOLVED	2
STATEMENT	2
SUMMARY OF ARGUMENT	3
ARGUMENT	4
I. TAXPAYER'S SALE OF CLOCK RESTAURANTS TO ROBERT O. PETERSON WAS COMPLETED IN 1956.	4
II. THERE IS NOTHING IN THE RECORD TO SUPPORT THE TAX COURT'S HOLDING THAT ROBERT O. PETERSON ASSUMED TAXPAYER'S OBLIGATIONS AS THE PURCHASE PRICE OF CLOCK RESTAURANTS AT ANY TIME IN 1956.	10
CONCLUSION	15
CERTIFICATE	15



## TABLE OF AUTHORITIES

<u>Cases</u>	<u>Page</u>
Crane v. Commissioner, 331 U.S. 1	13
Fawsett v. Commissioner, 63 F.2d 445	14
Landa v. Commissioner, 206 F.2d 431	9
Parker v. Delaney, 186 F.2d 455	14
Scofield v. Greer, 185 F.2d 551	9
Stern v. Commissioner, 137 F.2d 43	8
Thorsness v. United States, 260 F.2d 341	9
Woodsam Associates v. Commissioner, 198 F.2d 357	14

### Statutes

#### California Civil Code:

§1698	7
§1739(2)(a)	6, 8
§2468	12

### Rules

#### Rules of Tax Court of United States:

Rule 31(b)(5)	5
Rule 31(6)(5)	9

### Miscellaneous

Los Angeles Daily Journal, April 9 and 30, 1957	12
Webster's New World Dictionary, p. 1335	8





IN THE UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

FOREST G. SMITH, JR. and  
ROSE MARY SMITH,

Petitioners,

vs.

COMMISSIONER OF INTERNAL  
REVENUE,

Respondent.

---

REPLY BRIEF FOR THE PETITIONERS

---

OPINION BELOW

The Opinion of the Tax Court is reproduced on pages 418-434 of the Record.

JURISDICTION

The jurisdictional matters are set forth on pages 1-4 of Petitioners' Opening Brief.

QUESTION PRESENTED

The questions presented are set forth on pages 11 and 12 of Petitioners' Opening Brief.



## STATUTES AND REGULATIONS INVOLVED

These are set forth at pages 4-11 of Petitioners' Opening Brief.

### STATEMENT

Accuracy requires the statement of the second sentence on page 7 of the respondent's brief to read: "These same assets had a fair market value on October 31, 1956, of at least \$603,687.96 (R. 386-387, 424), the amount of taxpayer's liabilities, subject to which Peterson accepted the restaurants (R. 421, Item 4, R. 434) and which liabilities were personally assumed by Peterson in agreements he made with Smith's creditors on or about February 27, 1957 (R. 309-349, Exs. 20-T-24 to 43)."

The final paragraph on page 10 of respondent's brief can be stated in a more informative manner. It should read: "B.D.S. Company, a co-partnership formed on or about March 27, 1957, desired to acquire all of the assets of Clock Restaurants from Robert O. Peterson as of January 1, 1957 (R. 255, 257, 268-272, 412-413). To that end Robert O. Peterson and B.D.S. Company, at a time subsequent to the formation of the co-partnership on or about March 27, 1957, executed an instrument entitled 'Assignment' which the parties signed as of January 1, 1957 (R. 255-256). The Articles of Limited Partnership of B.D.S. Company were acknowledged by the partners on March 27, 1957 (R. 268-272). The Articles of Co-Partnership recited that the parties desired to



combine the assets of Robert O. Peterson, doing business as Clock Restaurants, with the assets of the limited partnership. " (R. 257).

On February 27, 1957, a letter wherein Robert O. Peterson was in the opening sentence named as 'the undersigned' circularized the taxpayer's creditors. In each letter the 'undersigned' (Robert O. Peterson) specifically assumed the balances payable on the indebtedness of Smith. All of the creditors subsequently accepted the offer of Peterson as set forth in these letters (R. 43, 309-349).

It has been stipulated that Peterson's agreement and understanding of the purchase price for the assets purchased under the agreement of October 31, 1956, was that he would take the assets subject to liabilities of \$603,687.96 and it was further stipulated that neither the petitioners nor the respondent might introduce evidence of any facts inconsistent with that stipulated fact (R.421 (4) (3), R. 33, 37 (7), R. 43 (22) ). The Tax Court excluded Peterson's testimony as to his understanding of the purchase price from evidence for the reason that the written contract itself was clear (R. 389).

### SUMMARY OF ARGUMENT

#### 1.

The Tax Court's conclusion that the sale of Clock Restaurants to Peterson was completed in 1956 is unsupported by the evidence, contrary to the facts stipulated by respondent and the



petitioners and clearly erroneous.

The agreement entered into between Forest G. Smith, Jr. and Robert O. Peterson, on October 30, 1956, was an agency agreement for the conduct of the business of Clock Restaurants accompanied by an executory sales agreement. The sales agreement, in oral form, was executed on or about February 27, 1957 when Peterson agreed to assume the debts of Smith.

## ARGUMENT

### I.

#### TAXPAYER'S SALE OF CLOCK RESTAURANTS TO ROBERT O. PETERSON WAS COMPLETED IN 1956.

---

It was stipulated by the respondent and the petitioners that "Forest G. Smith, Jr., one of the petitioners herein, and Robert O. Peterson, entered into an agreement bearing date October 30, 1956, a correct copy of which agreement is attached hereto and marked Joint Exhibit 6-F." (R. 37). Exhibit 6-F is the contract involved (R. 420-423). The Tax Court fully set forth the agreement as one of its findings of fact (R. 419, 420-423). It was primarily stipulated by the respondent and the petitioners that neither of them might introduce any evidence inconsistent with the fact that Exhibit 6-F was a correct copy of the agreement between Forest G. Smith, Jr. and Robert O. Peterson of October 30, 1956 (R. 33). In effect the stipulation applies the parol evidence rule to the respondent in this case insofar as the agreement between Smith





and Peterson is concerned. Counsel for the respondent, in response to direct questions asked him by the judge of the Tax Court during the course of the trial of the action, agreed that the terms of the agreement of October 30, 1956 were clear (R. 389, 398, 399).

The respondent's brief twice alludes to the fact that the taxpayer did not testify before the Tax Court (pp. 18, 26). The only legitimate inference that can be drawn from this failure to testify is that a correct copy of the agreement which Forest G. Smith, Jr. made with Robert O. Peterson on October 30, 1956 had been introduced in evidence as a stipulated fact with a concurrent stipulation that no evidence of any inconsistent fact might be introduced.

Petitioners and their counsel relied upon the stipulation of respondent's counsel as well as Rule 31 (b)(5) of the Tax Court that no evidence tending to qualify, change or contradict any fact properly introduced into the record by stipulation might be offered. There was no reason for Smith to testify as to facts that had already been stipulated to. Actually, as will be hereafter pointed out, Peterson's testimony upon which respondent's brief so heavily leans concerned agreements that Peterson subsequently made with Smith's creditors, and not the one he made with Smith. Peterson's testimony reconciles with the stipulated terms of the agreement of October 30, 1956 (Ex. 6-F) and the rules of the Tax Court when it is considered that he was not talking about Exhibit 6-F but about Exhibits 20 T, 1-43 (R. 285-349). The Tax Court itself excluded the testimony of Peterson as to what he understood the consideration for the agreement of October 30, 1956 to be (R. 389).



By the terms of the agreement of October 30, 1956, it is clear that Smith and Peterson both recognized that the demands of Smith's creditors were so pressing that an executed sales agreement could not be worked out between them before the creditors moved in and closed the business of Clock Restaurants. Peterson was not willing to commit himself to the purchase of the restaurants at that time but was willing to advance the money to pay off the most insistent of Smith's creditors. To protect these advances he was placed in control of the restaurants as the agent of Smith and was to remain in that position until a bulk sales escrow could be closed. The Tax Court correctly found the provision concerning a bulk sales escrow to be an option granted Peterson which he could exercise or not as he saw fit (R. 429).

It is, however, submitted that the exercise of that option or its waiver was one of the conditions precedent to the termination of the agency between Smith and Peterson and not a condition subsequent to the sale of Clock Restaurants as the Tax Court concluded (R. 423 (9), 429). The possession of Clock Restaurants was initially delivered to Peterson, the buyer, on trial or approval. He signified his approval or acceptance to the seller on or about February 25, 1957, after he had the consents of Smith's creditors. At the time of his approval, title to Clock Restaurants passed to Peterson. Section 1739 (2)(a), California Civil Code.

Inasmuch as Peterson did not exercise his option to demand a bulk sales escrow and one was never opened the question of when and how the agency of Peterson created by the agreement of



October 30, 1956, was terminated arises. When did Peterson cease to be the agent of Smith in the operation of Clock Restaurants and become the owner?

In California the terms of a written agreement may be altered only by a written agreement or an executed oral agreement. Section 1698, California Civil Code. There is no evidence or any contention the agreement of October 30, 1956, was altered by a written agreement. It is admitted by all that Peterson did become the purchaser of Clock Restaurants and ceased to operate them as the agent of Smith. It necessarily follows that this changed relationship was created by an executed oral agreement. All of the evidence points to the fact that such an oral agreement was executed on or about February 25, 1957.

The best explanation of the metamorphosis is found in the testimony of respondent's witness Robert B. Ballantyne, an attorney who represented Peterson in the transaction.

"Well, I would like to say that these parties -- at least Mr. Peterson -- was relying on my advice in connection with this transaction at that time; and by the time we had the -- we were in possession of the restaurants and had operated them for several months and had contacted the sellers' creditors and found that they were not going to -- or, rather, that they would go along with the transaction, we felt that an escrow was probably, by that time, of no importance and not necessary." (R. 406).



Webster's New World Dictionary, p. 1335, defines "several" as "more than two but not many".

The foregoing testimony of the respondent's witness establishes Peterson's operation of the Clock Restaurants as the agent of Smith lasted for "several", that is more than two, months after November 1, 1956 or until some time subsequent to January 1, 1957, before he decided to forego the exercise of his option to demand a bulk sales escrow.

There is in evidence a published and recorded notice of an intention of Smith to sell Clock Restaurants to Peterson, dated in February, 1957, and signed by Robert O. Peterson, which states that the sale, transfer and assignment of Clock Restaurants would be made and the consideration paid on February 25, 1957 (R. 412, 413). Before said date Peterson was advising Smith's creditors that he intended to purchase Clock Restaurants and to assume Smith's debts (R. 285-308). Two days after February 25, 1957, Peterson advised the same creditors that B. D. S. Company, of which he was a general partner, had completed the purchase of Clock Restaurants and did assume Smith's debts (R. 309-349). At that time he expressed the buyer's approval of which Section 1739 (2)(a) of the California Civil Code treats and title to Clock Restaurants passed from Forest G. Smith, Jr. to Robert O. Peterson.

The respondent misconstrues the basis of the contentions on pages 21-29 of the petitioners' opening brief. It is of course well established that the parol evidence rule only applies to the parties to a contract as the cases of Stern v. Commissioner, 137







F.2d 43; Thorsness v. United States, 260 F.2d 341; Landa v. Commissioner, 206 F.2d 431; Scofield v. Greer, 185 F.2d 551, hold. However, it is submitted that when the Commissioner has stipulated that a written document is a correct copy of the agreement of the parties and that he will offer no evidence inconsistent with that fact he has also agreed that the parol evidence rule is binding upon him with respect to the instrument and may not thereafter introduce evidence that goes behind the written contract. The true facts with respect to the terms of that contract are settled by the terms of the contract itself when the stipulation is received in evidence. Rule 31(6)(5) of the Tax Court. The contract is clear and it said Peterson was the agent of Smith.

Thus it clearly appears that the written contractual cocoon of October 30, 1956, was ruptured by an executed oral sales agreement on February 25, 1957. "The pupa emerged as a butterfly." Robert O. Peterson ceased to operate Clock Restaurants as the agent of Smith and became their owner. That was the day Smith actually sold Clock Restaurants. The statement in taxpayer's 1957 income tax return that Clock Restaurants were sold as of October 31, 1956, is at best the legal conclusion of a layman. That conclusion could be offered by neither party to vary the clear terms of the agreement of October 30, 1956 (Ex. 6-F, R. 420-423). It should be noted that the 1957 return reported a gain of \$220,271.34 from the sale of Clock Restaurants (R. 136, 428). The respondent accepted neither the 1956 nor the 1957 income tax return of the taxpayer as being correct. Otherwise the pending controversy



would never have arisen.

It is submitted that there is no evidence to support the Tax Court's conclusion that the taxpayer's sale of Clock Restaurants to Robert O. Peterson was completed in 1956.

## II.

THERE IS NOTHING IN THE RECORD TO  
SUPPORT THE TAX COURT'S HOLDING THAT  
ROBERT O. PETERSON ASSUMED TAXPAYER'S  
OBLIGATIONS AS THE PURCHASE PRICE OF  
CLOCK RESTAURANTS AT ANY TIME IN 1956.

---

It was stipulated by the respondent and the taxpayer that the agreement of October 30, 1956 provides: "Peterson hereby agrees to accept all of the above and foregoing assets and to pay therefor by taking them subject to the liabilities." (R. 421, emphasis ours). It was further stipulated that neither party might introduce any evidence inconsistent with that fact (R. 33). It has already been pointed out in this brief that the same agreement provides Peterson temporarily took over the assets as the agent of Smith and not as a purchaser.

It is also a stipulated fact that on November 29 and 30, 1956, Peterson made tentative offers to at least 21 creditors to assume Smith's debts to them if those creditors would alter the terms and extend the times of payment of the debts owing them (R. 42, §21, R. 285-308, Joint Exhibits 20 T, 1-23). It was further stipulated that on February 27, 1957 Robert O. Peterson entered into a separate agreement with each of 20 of Smith's creditors to actually



assume the debt owing them by Smith (R. 43, Joint Exhibits 20 T, 24-45 found at R. 309-349). It is true that Peterson was asked what his understanding of the purchase price of the assets was by respondent's counsel and, over objection by petitioner's counsel, said "I assumed the liability I was going to pay them" (R. 389, lines 19-20). If the answer had been allowed to stand it would have been a nullity because it was inconsistent with the stipulated fact that Peterson agreed to pay for the assets by taking them subject to the liabilities (R. 421). The Tax Court sustained an objection to that evidence (R. 389).

It is submitted that the Tax Court's finding of fact that "as a part of the consideration for Smith's sale of the restaurants to Peterson, Peterson assumed these liabilities" (R. 424) is supported by no evidence that the assumption took place in 1956. The Tax Court made no finding as to the year in which Peterson assumed Smith's debts. Peterson's assumption of the liabilities in 1957 was the consideration he gave creditors in 1957 for an extension of time within which he might pay the liabilities, not a part of the consideration he gave Smith for the purchase of the assets.

Respondent's brief states it to be a fact that effective January 1, 1957, Peterson sold Clock Restaurants to B. D. S. (Br. p. 19). Respondent's brief again states "in the agreement dated January 1, 1957, by which Peterson sold the Clock Restaurants to B. D. S. , he repeatedly acknowledged that he previously had assumed the liabilities of taxpayer pertaining to the Clock



Restaurant property (R. 255-256)" (Br. p. 25). Neither statement is accurate.

Nowhere on pages 255-256 of the record is it even once stated that Peterson had assumed the liabilities of the taxpayer. It is stated on page 256 of the record that B. D. S. assumed the liabilities of Peterson. Peterson himself did not incur the liabilities until February 27, 1957 (R. 309-349). At no place in the instrument of Assignment does it state that any one had assumed any of the liabilities of Smith (R. 255-256).

In the second place other evidence in the record discloses that although the assignment found on pages 255-256 of the record is dated "as of" January 1, 1957, it was actually executed on or about March 27, 1957, at a time subsequent to February 27, 1957, when Peterson is first shown by any evidence to have assumed Smith's debts (R. 309-349). First in the chain of circumstances are "Articles of Limited Partnership of B. D. S. Company" signed "as of" January 1, 1957, but acknowledged by the parties on March 27, 1957, a month after Peterson had assumed Smith's liabilities (R. 257-271). Corroborative of the fact that the limited partnership agreement was made considerably later than January 1, 1957, is Joint Exhibit 24 (set forth in full at page 414 of the Record; R. 45). This exhibit is a copy of B. D. S. 's Certificate of Business Under Fictitious Name. It is stipulated that it was published in the Los Angeles Daily Journal on April 9 and 30, 1957 (R. 45). Section 2468 of the California Civil Code provides that the Certificate must be filed and published "within one month after the commencement







of said business, or after the formation of the partnership, or within one month from the time designated in the agreement of its members for the commencement of the partnership. " The partnership agreement does not designate a time for the commencement of the partnership. It does provide that the partnership shall continue until December 31, 1966 (R. 259). It is to be presumed that the partners and their counsel were familiar with and obeyed this law of California. It follows that the business Clock Restaurants was not transferred to B.D.S. by Peterson on January 1, 1957, but occurred later than February 27, 1957.

It should be noted that the preliminary paragraphs of the said Articles of Limited Partnership recite that the parties desire to combine the assets, subject to the liabilities, of Robert O. Peterson, doing business as Clock Restaurants, with the assets of the limited partnership (R. 257). Article II, section 1 of the partnership agreement provides: "The partnership shall engage in the restaurant business under the name of Clock Restaurants. " The Certificate of Business under Fictitious Name certifies that "the partnership is conducting a restaurant and drive-in business under the fictitious name of Clock Restaurants. "

It is submitted that there was no evidence before the Tax Court that would support a finding that Forest G. Smith's debts were assumed by Robert O. Peterson at any time prior to 1957.

The case of Crane v. Commissioner, 331 U.S. 1, has already been discussed at length on pages 37-46 of petitioners' opening brief.



The case of Parker v. Delaney, 186 F.2d 455, cited at page 29 of respondent's brief deals with the effect of depreciation taken upon apartment houses on the taxpayer's adjusted basis for computing gain or loss when he sold the apartment houses. There is no controversy here about the amount of gain realized by the taxpayers nor of the basis for computing that gain.

In Woodsam Associates v. Commissioner, 198 F.2d 357 (p. 30, respondent's brief), also involves a dispute over the basis for computing gain or loss. That issue is not present in the pending case.

Fawsett v. Commissioner, 63 F.2d 445 (p. 30, respondent's brief), has to do with a dispute as to the year in which the taxpayer who had received cash from the sale of real estate should report it as income. It was held to be the year in which she received the cash. That is not one of the questions here presented.

It is submitted that there is no evidence that Forest G. Smith, Jr. realized or received any gain in 1956 of more than \$36,308.68, the excess of his debts (\$326,443.08) which Peterson paid in 1956 (R. 425) over the adjusted basis of Clock Restaurants (\$290,134.30) (R. 42).



CONCLUSION

It is respectfully submitted that the decision of the Tax Court should be reversed.

Dated: August 26, 1963.

Respectfully submitted,

ERNEST R. MORTENSON

EUGENE HARPOLE

By /s/ Eugene Harpole

EUGENE HARPOLE

Attorneys for Petitioners

CERTIFICATE

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit and that in my opinion this brief is in full compliance with those rules.

/s/ Eugene Harpole

EUGENE HARPOLE

